

## "FINANCING CO-OPERATIVES"

(Speech to be delivered on 23rd June 1984 by  
Michael Eyers, consultant to FIR)

I have spent a fascinating five months working with the "Financial Institutions Review" or FIR as it inevitably came to be called, mainly looking at two types of financial institutions, building societies and credit societies. In a broad sense these are all co-operatives. I doubt the last few months have made me an expert on the subject of financing co-operatives, however. This is partly because co-operatives other than building societies and credit societies cannot, as the law now stands in Victoria, borrow from credit societies and rarely would be in a position to require residential mortgage finance from a building society. In consequence, the two sorts of co-operative that I have been looking at don't have much to do with other sorts of co-operatives. The question is, should they be encouraged to?

In discussing that question, there are three things I will need to consider:

- (a) the capital base of co-operatives
- (b) Aesop's fable of the bound sticks
- (c) the proposal for a co-operative bank.

But before I embark on that task - and I am sorry for the diversion, because I know you are waiting with bated breath - I propose to diverge to add my mite on the question of what distinguishes a co-operative.

When one looks at the various pigeon holes provided by the Co-operation Act - and comparable legislation in other states - not much of the nation's economic activity is undertaken by organisations which attract the name "co-operative". This is especially so if one excludes credit societies. You certainly couldn't call 175 producer and trading co-operatives with gross assets (not merely capital and reserves) of only \$40M together with 1,000 - odd community advancement and community settlement societies an irresistible economic force.

But as the MACC paper points out, the figures grow if one changes the grouping and adds a label "co-operative organisations incorporated under other statutes". Building societies, a number of companies, industrial and provident societies, co-operative housing societies and other entities join the group; but the sector, if that is what it is, is still pretty small if the financial co-operatives - building societies and credit societies - are excluded.

If one adds another label to include mutual organisations - and in a moment I will suggest that this change is justified - then there is a great change in the economic significance of the grouping. Welcome friendly societies and benefit associations; welcome AMP, the National Mutual, and other mutual insurers.

Why should a mutual organisation be included as a co-operative? Well, when I try to work out what the term co-operative means without reference to the legislative pigeon holes, I cannot find an alternative to "a member-owned business or investment

undertaking". The central distinction between these and other undertakings is in the ownership of capital. Let me emphasise that the distinction is not - or certainly ought not to be - in the level of capital but in its ownership. Too often co-operatives are seen as anti-capital, and probably too often co-operatives are undercapitalised. But being undercapitalised is not what co-operatives should be about.

It is the member-owned characteristic that is important, and in this respect I cannot see any distinction between mutual insurers and other co-operatives. Organisations are co-operatives if their capital is owned by the participants in the business or investment undertaking. The legislative pigeon holes are not the test.

The fact that co-operative businesses are owned by the participants is an immense advantage if properly emphasised and presented. If in addition co-operatives can have the characteristic of being comparatively small, democratic and community oriented organisations, without loss of financial and economical strength, then participation in co-operatives and organising business and investment undertakings in this way should be extremely attractive.

It is interesting to think about what sort of undertakings seem to suit co-operative structures. Ironically enough, if you consider co-operatives ought to be anti-capital, the structure is ideally suited to funds pooling. Because members' inputs are money rather than time or skills, you avoid the difficulty of

determining what is the equitable return for different types of inputs. Mutual insurers have become very substantial organisations, no longer small-scale but still very attractive partly because surpluses are returned to members - a fact constantly emphasised by the insurers themselves. By comparison with these organisations, building societies and credit societies are pretty small, even though they are the largest component of what we normally think of as co-operatives. One reason they may not have acquired the size of the big mutual insurers is that funds contributed to insurers cannot be withdrawn as easily as funds contributed to building societies and credit unions.

As the FIR report points out in a discussion on the "pure" co-operative structure, the logic is that if participants are to own capital, capital should be withdrawn by a participant withdrawing from the enterprise. Withdrawable capital is, I think, the central problem in the financial structuring of co-operatives. Building societies and credit societies have low reserves by comparison with other financial institutions. Low reserves impose on financial institutions a requirement to earn on all assets each year, and that prevents long term investments which may not show a return for a year or two. But it is not only financial co-operatives which suffer from undercapitalisation. A few years ago I acted as the solicitor advising merchant bankers who were trying to save a big retail store co-operative in New South Wales. The problem was that people who had kept savings accounts with the co-operative were withdrawing their money, and this meant that what was quite a big business was suffering a rapid contraction in its working

capital. The directors, unfortunately as it turned out but nonetheless with good reason, were averse to using powers which they did in fact have under the co-operation legislation in New South Wales to freeze members accounts. Because they were not prepared to do that, each refinancing proposal to borrow working capital from outside financiers was out of date by the time draw down date approached. In the event, the co-operative was unable to borrow sufficient substituted working capital and it went into liquidation.

The conclusion is simply inescapable that some form of permanent or near-permanent capital base is necessary for co-operatives, especially financial co-operatives, in today's economic scene. FIR has recommended that financial co-operatives (which I will now use to mean building societies and credit societies, but not mutual insurers) should be able to raise a type of permanent capital which is similar to subordinated debt. That is one of the recommendations of the Review on which reactions from co-operatives would be particularly welcome. More thought needs to be given to the source of permanent capital, and that will help the movement and government to work out what types of capital, or perhaps subordinated debt, should be permitted and are likely to be successful. Obviously, there is a real strain here between the co-operative principle of "one member one vote" and the need to give those who provide permanent capital some recognition of the fact that they are the risk-taking members of the co-operative. Some guarantee of minimum Board representation may be a solution, but this is a tentative suggestion.

Associated with the question of capital is the requirement for minimum reserves and the rules, particularly applicable to credit societies, requiring provisions for loan accounts in arrears. The recent statutory amendments in New South Wales and Victoria represent a firm commitment by government to ensuring that no criticism whatsoever can be directed at the building society industry or the credit society movement because of poor levels of reserves or provisions. The problem becomes to ensure that reserves actually reach the levels aimed at by legislation. If permanent capital is treated as part of the reserve base, as it should be, raising permanent capital may be a way of reaching reserve levels much more quickly than transfers from surplus - which may well be hard to come by in the next year or two.

As the winds of change blow away the fences which have insulated building societies and credit societies from banks - and I mean the regulation of savings banks which has benefited building societies for most of the last twenty years, and the payroll deduction mechanism which has helped credit societies for most of the same period but is now under threat - interesting questions of scale arise when one looks at deposit taking institutions. Banks are very large; credit societies are often very small. There are many reasons why it is desirable to have small deposit taking institutions operating in the Australian financial system, but we can no longer pretend that small institutions can survive unsupported. They must have industry infrastructure. Credit societies have such an infrastructure, consisting of the VCCA in Victoria and the emerging national finance facility for credit societies, and the Financial Institutions Review came to the

conclusion that the national infrastructure should be developed as quickly as possible and that participation in the infrastructure, at least on financial matters such as liquidity support and funds management, should be compulsory for each credit society. This cannot happen all at once; probably compulsory participation in industry-provided liquidity support facilities will be feasible long before it is feasible to require credit societies in effect to bank with the movement. But in my view there is no reason why that objective should not be stated now. The credit society movement as a whole will not be able to afford in a deregulated Australian financial system a situation where an individual large credit union can be seduced away from industry banking and financial arrangements through loss-leading deals presented by private banks. This is not paranoia - it is just recognising the fact that the collective assets of the credit society movement in Australia are about a quarter of the assets of the smallest of the present nationally operating private banks. In other words, the capacity to offer loss-leading arrangements clearly exists in the private banks and there is no reason to suppose that that capacity will not be used if an advantage is perceived.

Building societies are not bound together as strongly as credit societies, to continue the Aesop's fable metaphor. Most need to be, and that is why FIR's recommendations emphasise so heavily the development of infrastructure in the building society industry. Some building societies may be big enough to survive in a deregulated financial environment either by themselves or in national combinations. The Review's opinion was, however, that

constructing industry infrastructure is the necessary first move; allowing organisations which wish to move outside the infrastructure to do so is a luxury the building society industry collectively cannot at present afford. Nonetheless, in the long term, of the financial institutions which at present bear the label "building societies" some are likely to seek to operate by themselves, perhaps after industry rationalisation, and some will remain linked to the industry infrastructure.

As I mentioned a moment ago, as infrastructure develops in response to competitive measures in the Australian financial system, it will become necessary for participation in infrastructure to be compulsory. Participating societies will not be able to think of themselves as independent organisations which can choose to deal or not deal with competing State-level organisations like the VCCA or national financial organisations such as Credit Union Financial Services Australia Limited. Societies will have to see themselves as being of necessity members of the financial grouping that deals with those state and national level organisations - and there will be only one infrastructure. Whilst sticks bound in a bundle remain sticks, the fact that they are in a bundle means they lose their freedom to wave around by themselves.

From this structure there may well evolve a co-operative bank. The MACC information paper deals at paragraphs 110 to 117 with the proposal for a co-operative bank. I suppose that really a co-operative bank is a proposal only in the sense that homo sapiens was a proposal when the first primates had evolved -

although the pace of evolution has picked up since then.

The first step along what I see as the likely evolutionary path will be development of credit society infrastructure to the point where it is feasible for all banking services required by individual credit societies to be provided from within the credit society movement. Before this is possible, arrangements for access to the clearing system for paper instruments - cheques and negotiable orders of withdrawal - will have to change. This process has already begun, and it is likely that by the time credit societies - and those building societies which take this path - reach this stage of cohesion, what people understand by a "bank" in Australia will have changed significantly. The change will result partly from the greater diversity in the nature of organisations holding banking licences after new licences are granted this year; technological change will have its contribution, by making it harder to maintain the distinction between banks and non-bank financial institutions. When building societies and credit societies have access to the paper payment system and electronic funds transfer systems involved in point of sale transactions with plastic cards, the distinction will increasingly become one between deposit taking institutions and others. This categorisation puts building societies and credit societies in the same group as banks.

So in a changed environment, the stage is likely to be reached where member-owned financial organisations, organised on the model of small primary organisations with industry or wholesale financial support structures, are ready to extend the range of

banking services they offer and extend the range of clients to whom they offer them. Here I take a somewhat different tack from the MACC paper. The paper emphasises the provision of services by a co-operative bank to other co-operatives, particularly housing co-operatives and community organisations which may not strictly speaking be co-operatives and may not be business undertakings. Of course these are important client groups which a co-operative bank should be especially keen to service. The base deposit-taking organisations, themselves comparatively small and community oriented, should be particularly predisposed to this sort of community-oriented activity - not as welfare agency but as a banker and financial counsellor.

But the assets side of a co-operative bank I see as involving links not only with other co-operatives and not only with personal borrowers, but with the whole range of clients for banking services. In Australia the household sector is a net saver, and the only sector which consistently remains a net saver. So the objective at which a co-operative bank can aim is to leave direct dealings with the household sector to the primary level organisations in each community, with the co-operative bank in its own name dealing with a full range of corporate and one would hope government clients and providing normal banking services to them.

You cannot call what I have just outlined a model in any operational sense. The outlines of what is practicable will only emerge as the preliminary steps are completed, as financial integration of the credit society movement proceeds, and as the

clearing system of paper and electronic transactions change and open up. My topic, financing co-operatives, points to two developments which should be aimed at. One is the provision of finance to co-operatives by co-operatives and the other is the strengthening of co-operatively owned financial organisations so that instead of being in some significant senses clients of private banks co-operatives can be involved in financing all sectors of the economy through a co-operative bank.

W2B1